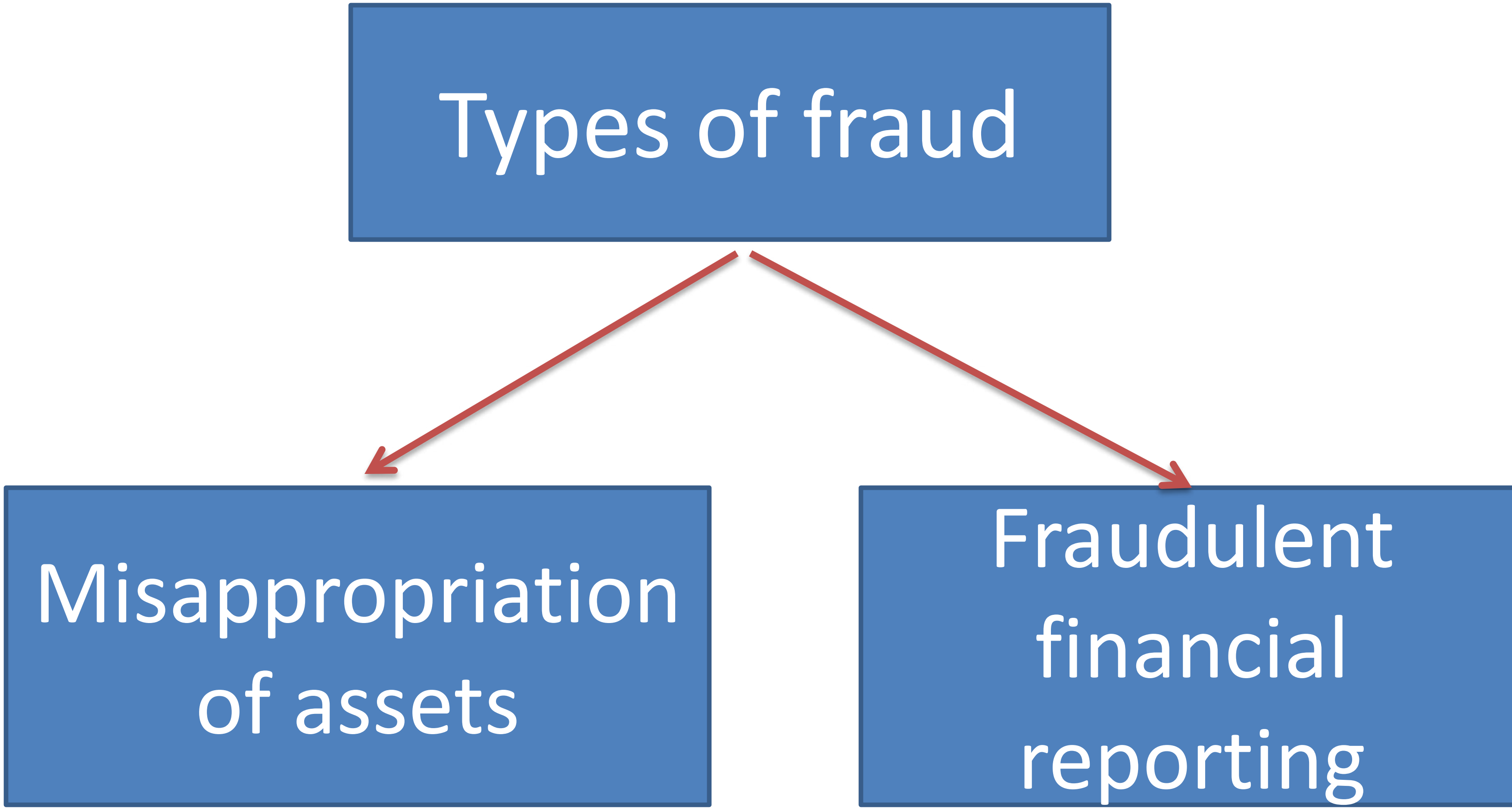
Ch 11

Fraud Auditing

- Fraud:- any intentional act to do something wrong. Any intentional deceit meant to deprive another person or party of their property or rights. Any intentional misstatement.

- Error:- any unintentional misstatement.


Types of fraud
Misappropriation of assets
Fraudulent financial reporting

Misappropriation of assets

- Generally, done by the employees.
- Fraud that involves theft of an entity’s assets.
- Amounts involved are not material to the financial statements. However, the theft of company assets is often a management concern because small thefts can easily increase in size over time.

Fraudulent financial reporting

- Generally, done by the management.
- intentional misstatement or omission of amounts or disclosures in the financial statements with the intent to deceive users.
- Examples:- deliberate overstatement of assets or income, omission of liabilities. Sometimes, companies may understate income to reduce income taxes.

Fraudulent financial reporting

This can be done by ***Earning Management***, which involves deliberate actions taken by management to meet earnings objectives.

- Earning Management has many techniques, one of them is called ***income smoothing*** in which revenues and expenses are shifted between periods to reduce fluctuations in earnings.

Fraudulent financial reporting

- Examples to income smoothing:-

Overstating inventory obsolescence in the periods they would like to reduce income.

Loss	***xx***	
Inventory		xx

Overstating allowance for doubtful accounts in the periods they would like to reduce income.

Bad debt expense	***xx***	
Allowance for doubtful accounts		xx

Which of the following best defines fraud in a financial statement auditing context?

A) Fraud is an unintentional misstatement of the financial statements.

B) Fraud is an intentional misstatement of the financial statements.

C) Fraud is either an intentional or unintentional misstatement of the financial statements, depending on materiality.

D) Fraud is either an intentional or unintentional misstatement of the financial statements, depending on consistency.

Companies may intentionally understate earnings when income is high to create a reserve of "earnings" that may be used in future years to increase earnings. This practice is known as:

A) performance-based management.

B) earnings management.

C) asset management.

D) expense management .

Which of the following is a category of fraud?

	Fraudulent financial reporting	Misappropriation of assets
a	Yes	Yes
b	No	No
c	Yes	No
d	No	Yes

With respect to misappropriation of assets, most frauds involve

	Inventory or liquid asset theft	Intentional misstatements of amounts
a	Yes	Yes
b	No	No
c	Yes	No
d	No	Yes

______________________________is fraud that involves theft of an entity's assets.

A) Fraudulent financial reporting

B) A "cookie jar" reserve

C) Misappropriation of assets

D) Income smoothing

Which of the following is a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings?

A) fraudulent financial reporting

B) expense smoothing

C) income smoothing

D) each of the above is correct

Who is most likely to perpetrate fraudulent financial reporting?

A) members of the board of directors

B) production employees

C) management of the company

D) the internal auditors

Misappropriation of assets is normally perpetrated by:

A) members of the board of directors.

B) employees at lower levels of the organization.

C) management of the company.

D) the internal auditors.

Three conditions of fraud

Why do people commit fraud?

Fraud has 3 conditions (fraud triangle), which are:-

1- Incentives/Pressures.

2- Opportunities:- Circumstances provide opportunities for management or employees to commit fraud.

3- *Attitudes/Rationalization:- An attitude, behavior, character, or set of ethical values exists* that allows management or employees to commit a dishonest act, or they are in an environment.

Fraudulent financial reporting

Pressures	Opportunities	Attitudes
Financial stability is threatened	Some significant accounting estimates that involve subjective judgments	Ineffective support of entity's values
Significant declines in customer demands.	Ineffective control by board of directors and audit committee	Known history of violations of laws and regulations
Business failures	High turnover of accounting, internal audit, and IT staff. (Low experience)	Management practice or personality of making overly aggressive or unrealistic forecasts
Pressure to meet debt repayment or debt covenant requirements		

Fraudulent financial reporting

Pressures

- Financial stability is threatened.
- Significant declines in customer demands.
- Business failures.
- Pressure to meet debt repayment or debt covenant requirements.

Fraudulent financial reporting

Pressures	Opportunities	Attitudes
Financial stability is threatened	Some significant accounting estimates that involve subjective judgments	Ineffective support of entity's values
Significant declines in customer demands.	Ineffective control by board of directors and audit committee	Known history of violations of laws and regulations
Business failures	High turnover of accounting, internal audit, and IT staff. (Low experience)	Management practice or personality of making overly aggressive or unrealistic forecasts
Pressure to meet debt repayment or debt covenant requirements		

Fraudulent financial reporting

Opportunities

- Some significant accounting estimates that involve ***subjective*** judgments.
- ***Ineffective control*** by board of directors and audit committee.
- ***High turnover*** of accounting, internal audit, and IT staff. (Low monitoring or oversight experience)

Fraudulent financial reporting

Pressures

- Financial stability is threatened
- Significant declines in customer demands.
- Business failures
- Pressure to meet debt repayment or debt covenant requirements

Opportunities

- Some significant accounting estimates that involve subjective judgments
- Ineffective control by board of directors and audit committee
- High turnover of accounting, internal audit, and IT staff. (Low experience)

Attitudes

- Ineffective support of entity's values
- Known history of violations of laws and regulations
- Management practice or personality of making overly aggressive or unrealistic forecasts

Fraudulent financial reporting

Attitudes

- Ineffective support of ***entity's values***.
- ***Known history*** of violations of laws and regulations.
- ***Management practice (attitudes)*** or personality of making overly aggressive or unrealistic forecasts. (overstating allowance for doubtful accounts)
- Dishonesty, and lack of commitment.

Fraudulent financial reporting

Pressures	Opportunities	Attitudes
Financial stability is threatened	Some significant accounting estimates that involve subjective judgments	Ineffective support of entity's values
Significant declines in customer demands	Ineffective control by board of directors and audit committee	Known history of violations of laws and regulations
Business failures	High turnover of accounting, internal audit, and IT staff. (Low experience)	Management practice or personality of making overly aggressive or unrealistic forecasts
Pressure to meet debt repayment or debt covenant requirements		

Which of the following is a factor that relates to ***incentives or pressures*** to commit fraudulent financial reporting?

A) Significant accounting estimates involving subjective judgments. Opportunities

B) Excessive pressure for management to meet debt repayment requirements. Pressures

C) Management's ***practice*** of making overly aggressive forecasts. Attitudes

D) High turnover of accounting, internal audit, and information technology staff Opportunities

Which of the following is a factor that ***relates to attitudes or rationalization*** to commit fraudulent financial reporting?

A) Significant accounting estimates involving subjective judgments. Opportunities

B) Excessive pressure for management to meet debt repayment requirements. Pressures

C) Management's practice of making overly aggressive forecasts. Attitudes

D) High turnover of accounting, internal audit and information technology staff. Opportunities

Which of the ***following is not a factor that relates to opportunities*** to commit fraudulent financial reporting?

A) Lack of controls related to the calculation and approval of accounting estimates. Opportunities

B) Ineffective oversight of financial reporting by the board of directors. Opportunities

C) Management's practice of making overly aggressive forecasts. Attitudes

D) High turnover of accounting, internal audit, and information technology staff Opportunities

Financial statement manipulation risk is arguably present for all companies' financial statements. However, the risk is elevated (increased) for companies that:

A) are heavily regulated.

B) have foreign subsidiaries.

C) have to make significant judgments for accounting estimates.

D) operate in stable economic environments

Misappropriation of assets

Pressures

Personal financial obligations

Adverse relationships between management and employees

Opportunities

Presence of large amounts of cash on hand or inventory items that are small of high value

Inadequate internal control due ***to lack of the following***:- Segregation of duties, job applicant screening, mandatory vacations.

Attitudes

Disregard for the need to monitor

Disregard for internal control

Misappropriation of assets

Pressures

- ***Personal financial obligations*** create pressure for those with access to cash or other assets susceptible to theft to misappropriate those assets.
- ***Adverse relationships*** between management and employees. For example:-

  **Known or expected employee layoffs.

  **Promotions, compensation, or other rewards inconsistent with expectations.

Misappropriation of assets

Pressures	Opportunities	Attitudes
Personal financial obligations	Presence of large amounts of cash on hand or inventory items that are small of high value	***<u>Disregard</u>*** for the need to monitor
Adverse relationships between management and employees	Inadequate internal control due ***<u>to lack of the following</u>***:- Segregation of duties, job applicant screening, mandatory vacations.	***<u>Disregard</u>*** for internal control

Misappropriation of assets

Opportunities

- Presence of large amounts of cash on hand or inventory items that are small, of high value.

- Inadequate internal control over assets due to ***lack of the*** following:-

Lack of appropriate segregation of duties.

Lack of job applicant screening for employees.

Lack of mandatory vacations for employees.

Misappropriation of assets

Pressures	Opportunities	Attitudes
Personal financial obligations	Presence of large amounts of cash on hand or inventory items that are small of high value	***<u>Disregard</u>*** for the need to monitor
Adverse relationships between management and employees	Inadequate internal control due ***<u>to lack of the following</u>***:- Segregation of duties, job applicant screening, mandatory vacations.	***<u>Disregard</u>*** for internal control

Misappropriation of assets

Attitudes

- ***Disregard*** by management for the need to monitor or reduce risk of misappropriation of assets.
- ***Disregard*** by management for internal controls by overriding existing controls or failing to correct known internal control deficiencies.
- ***Management attitude toward controls and ethics may allow employees and managers to rationalize the theft of assets***.

Misappropriation of assets

Pressures	Opportunities	Attitudes
Personal financial obligations	Presence of large amounts of cash on hand or inventory items that are small of high value	***<u>Disregard</u>*** for the need to monitor
Adverse relationships between management and employees	Inadequate internal control due ***<u>to lack of the following</u>***:- Segregation of duties, job applicant screening, mandatory vacations.	***<u>Disregard</u>*** for internal control

Which of the following is ***not a factor that relates to opportunities*** to misappropriate assets?

Opportunities

A) Inadequate internal controls over assets.

B) Presence of large amounts of cash on hand. Opportunities

C) Inappropriate segregation of duties or independent checks on performance Opportunities

D) Adverse relationships between management and employees Pressures

Which of the following is a factor that ***relates to incentives*** to misappropriate assets?

A) Significant accounting estimates involving subjective judgments. Opportunities

B) Significant personal financial obligations. Pressure

C) Management's practice of making overly aggressive forecasts. Attitudes

D) High turnover of accounting, internal audit and information technology staff. Opportunities

In the fraud triangle, fraudulent financial reporting and misappropriation of assets:

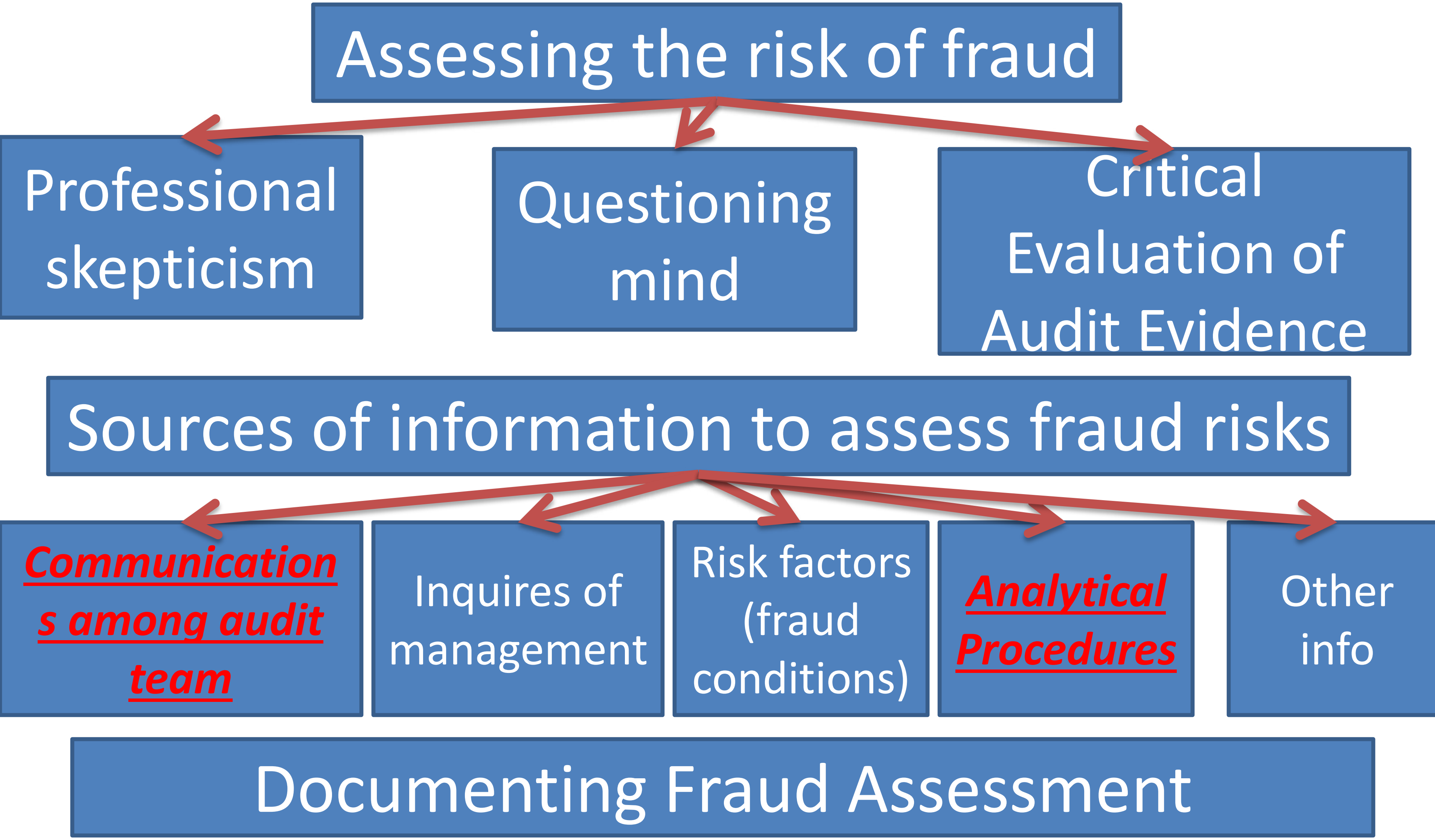
A) share little in common.

B) share most of the same risk factors.

C) share the same three conditions.

Pressures	Opportunities	Attitudes

D) share most of the same conditions


Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
Communications among audit team
Inquires of management
Risk factors (fraud conditions)
Analytical Procedures
Other info
Documenting Fraud Assessment

Assessing the risk of fraud

SAS 99 requires auditors to maintain level of professional skepticism during the audit.

Auditing standards state that, in exercising ***professional skepticism***, an auditor "*neither assumes that management is dishonest nor assumes unquestioned honesty.*"

You should not assume that management is completely dishonest or completely honest.

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***Communications among audit team***
- Inquires of management
- Risk factors (fraud conditions)
- ***Analytical Procedures***
- Other info

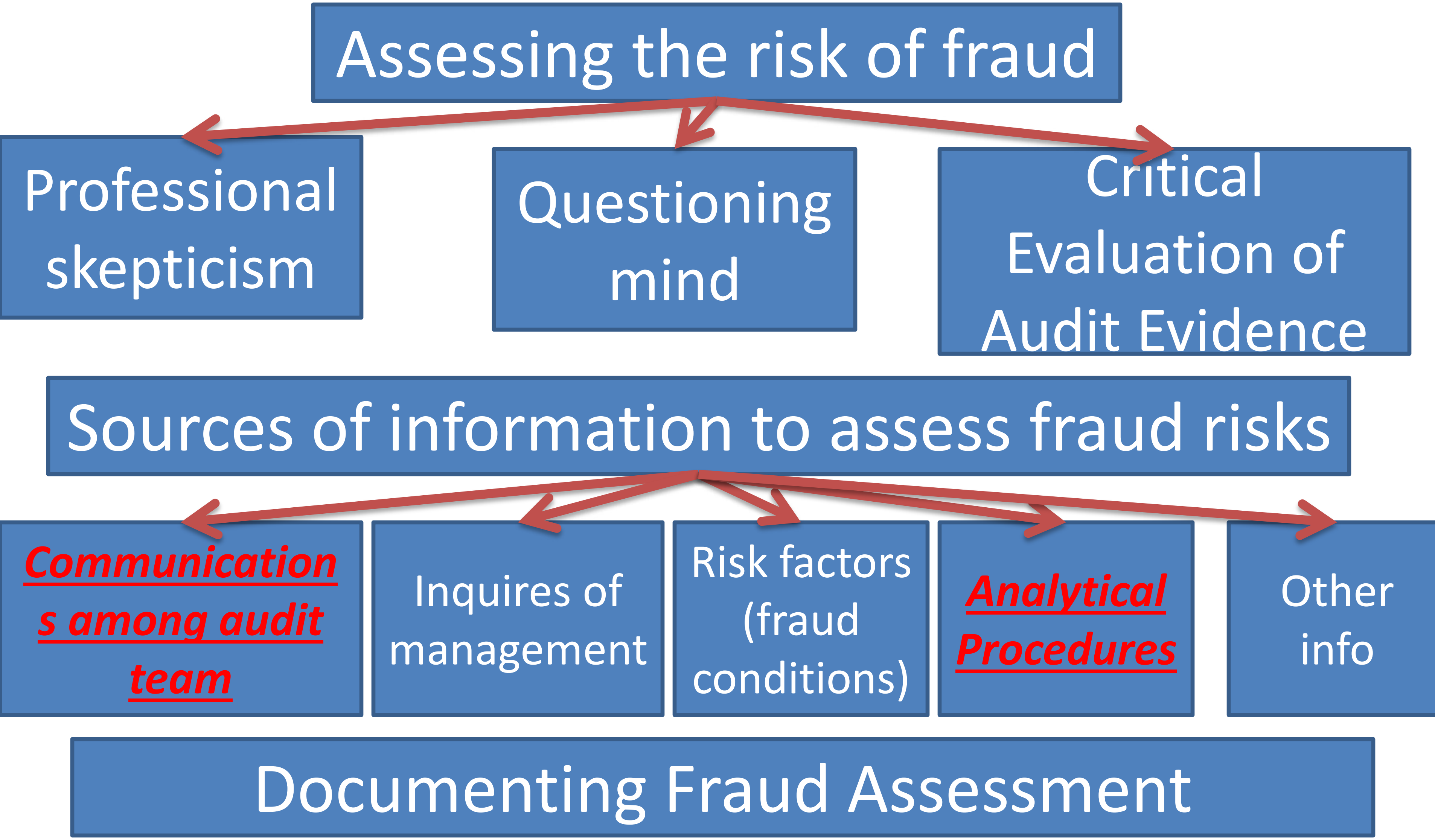
Documenting Fraud Assessment

Assessing the risk of fraud

The concept of ***questioning mind***.

Auditing standards emphasize consideration of a client's susceptibility to fraud, regardless of the auditor's beliefs about the likelihood of fraud and management's honesty and integrity.

There is always a risk that even an honest person can rationalize fraudulent actions when incentives or pressures become extreme.



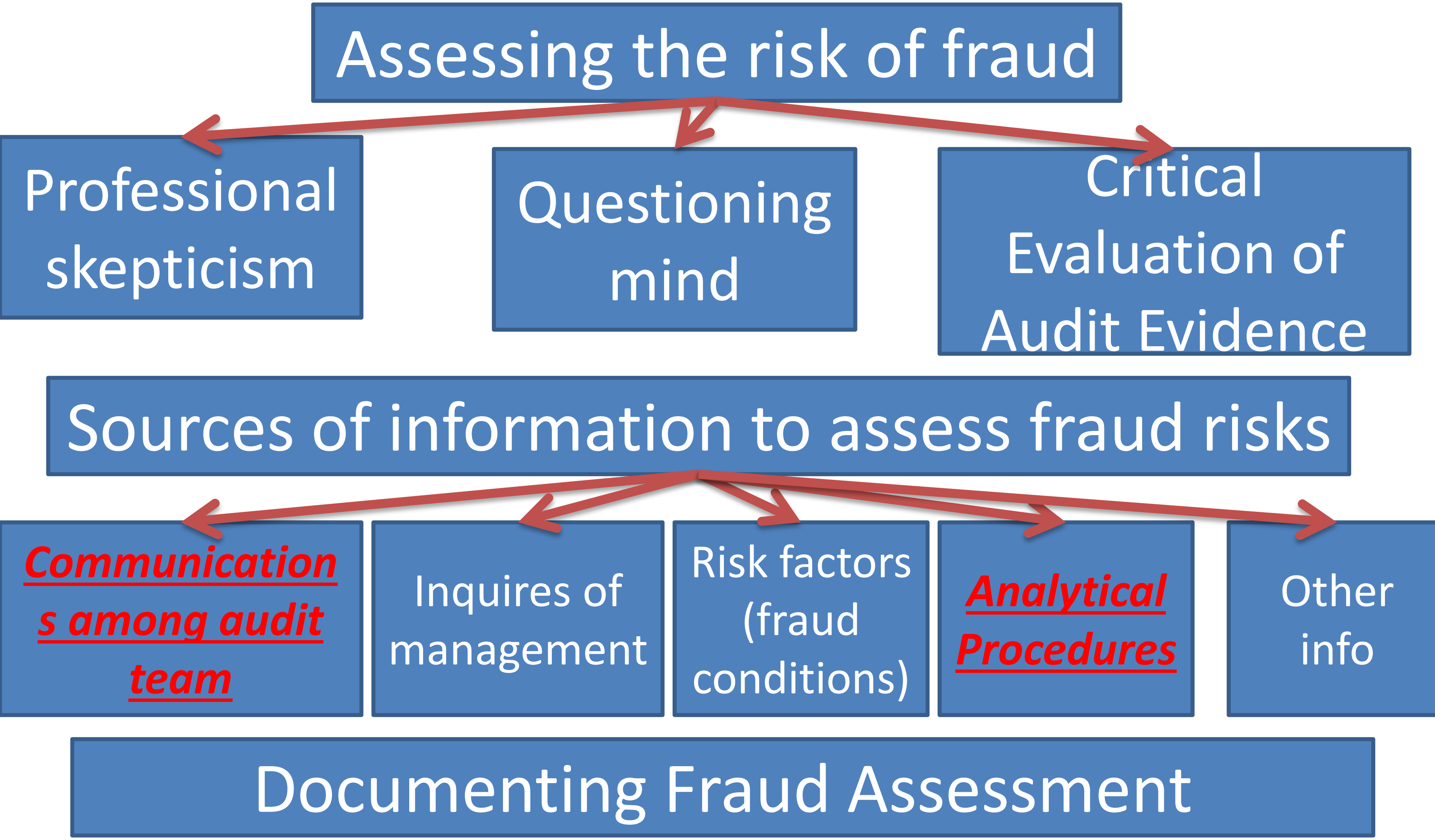
Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
Communications among audit team
Inquires of management
Risk factors (fraud conditions)
Analytical Procedures
Other info
Documenting Fraud Assessment

Assessing the risk of fraud

Critical Evaluation of Audit Evidence.

Auditors should thoroughly probe (investigate) the issues, acquire additional evidence if needed, and consult with other team members.

The auditor should evaluate the reasons for the misstatement, determine whether it was intentional or a unintentional, and consider whether other such misstatements are occurred.


Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
Communications among audit team
Inquires of management
Risk factors (fraud conditions)
Analytical Procedures
Other info
Documenting Fraud Assessment

Which of the following most accurately defines professional skepticism as it is used in auditing standards?

A) It either assumes management is honest or slightly dishonest, but neither all the time.

B) It neither assumes that management is dishonest nor assumes unquestioned honesty.

C) It assumes management is honest most of the time.

D) It assumes that management is dishonest in only rare instances

Auditor's need to exhibit professional skepticism when auditing a client. This auditing standard is best expressed by which of the following?

A) the auditor neither assumes dishonesty or honesty of management

B) the auditor assumes dishonesty of management

C) the auditor assumes honesty of management

D) the auditor assumes management lacks integrity

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***<u>Communications among audit team</u>***
- Inquires of management
- Risk factors (fraud conditions)
- ***<u>Analytical Procedures</u>***
- Other info

Documenting Fraud Assessment

Structure of CPA firm:-

Partner:- sign the audit report and has the ultimate responsibility for the audit.

Manager:- Review Senior auditors work and manages the relationships with clients.

Staff auditors or in-charge auditors:- responsible for planning and supervising audit field work and reviewing staff assistants.

Staff assistant:- performs most of detailed audit work.

Four phases of financial statement audit:-

Phase 1:- plan and design audit program.

Phase 2:- Performs tests of controls and substantive tests of transactions.

Phase 3:- Perform analytical procedures and tests of details of balances.

Phase 4:- Complete the audit and issue an audit report.

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***Communications among audit team***
- Inquires of management
- Risk factors (fraud conditions)
- ***Analytical Procedures***
- Other info

Documenting Fraud Assessment

Sources of information to assess fraud risks

Communications among audit team

Who should attend?

Members of the engagement, including partner, managers, senior auditors, and staff assistants. Also, it may include audit specialists in tax or IT who work on the audit engagement.

Sources of information to assess fraud risks

Communications among audit team

<u>When the session be held?</u>

Four phases of financial statement audit:-

Phase 1:- plan and design audit program.

Phase 2:- Performs tests of controls and substantive tests of transactions.

Phase 3:- Perform analytical procedures and tests of details of balances.

Phase 4:- Complete the audit and issue an audit report.

Sources of information to assess fraud risks

Communications among audit team

When the session be held?

During ***planning*** phase of the audit with the discussions about susceptibility of the entity's financial statements to other types of misstatements.

(so, discussions about fraud or errors).

Audit plan can be adjusted on the basis of these discussions.

Sources of information to assess fraud risks
Communications among audit team

What is the purpose of audit team brainstorming session?

The purpose is to exchange ideas and share insights from more experienced audit team members about:-

- How and where they believe the entity's financial statements might be susceptible to fraud. ***How management can perpetrate and conceal fraudulent financial reporting.***
- How any one might ***misappropriate the assets*** of the entity.
- ***Fraud conditions*** or risk factors (incentives, opportunities, and attitudes of management and employees.
- How the auditor may respond to that.

Assessing the risk of fraud

Professional skepticism

Questioning mind

Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

<u>Communications among audit team</u>

Inquires of management

Risk factors (fraud conditions)

<u>Analytical Procedures</u>

Other info

Documenting Fraud Assessment

Sources of information to assess fraud risks

Inquires of management

Auditing standards requires auditors to make specific inquiries about fraud in ***every audit***.

Inquires can be to the:-

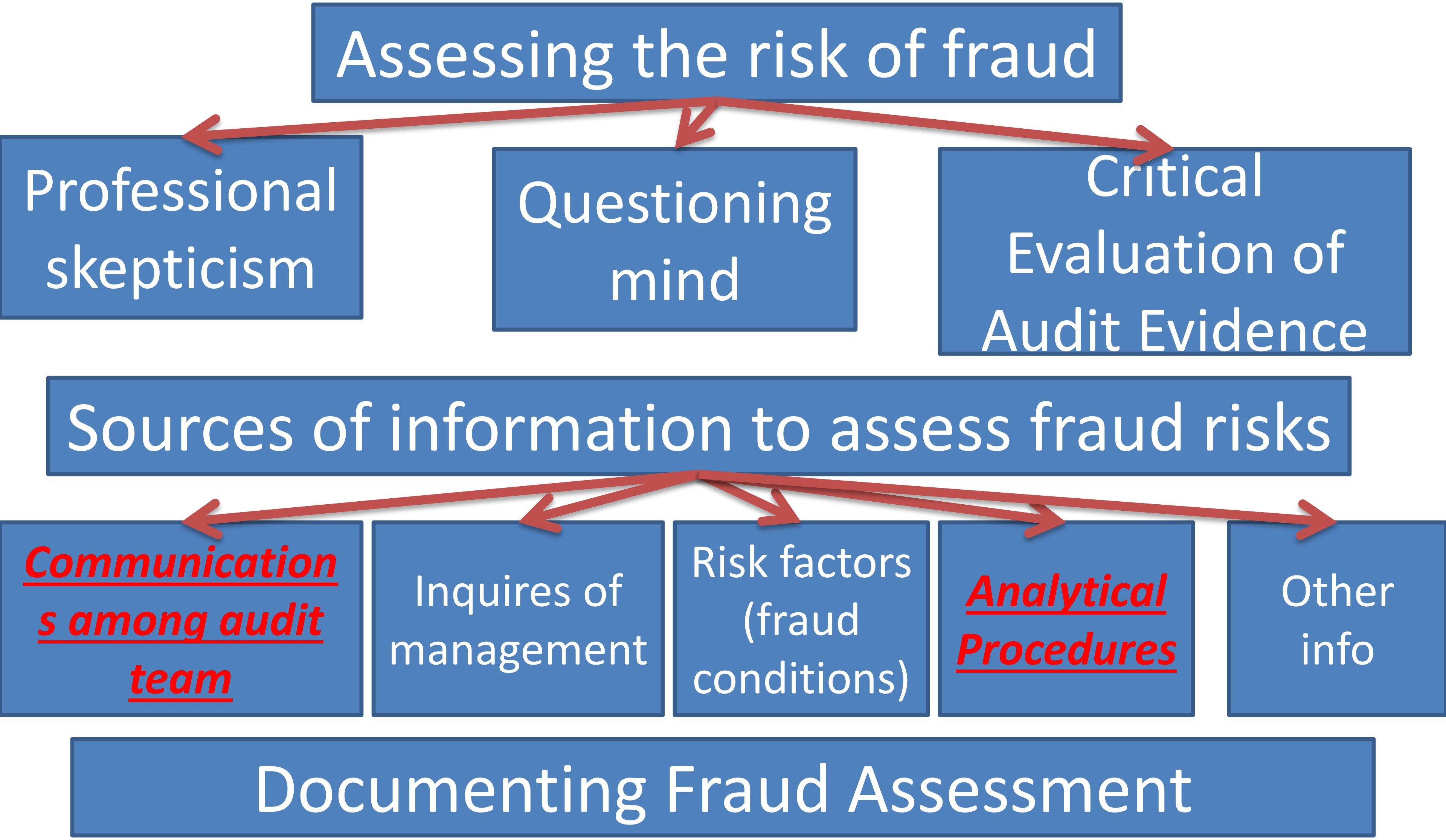
- Management
- Employees
- Another personnel within the entity whose duties lie outside the normal financial reporting lines of responsibility, like inventory warehouse agents, or purchasing agents.

Sources of information to assess fraud risks

Inquires of management

The auditor's inquiries of management should address ***whether management has knowledge*** of any fraud or suspected fraud within the company.

Inquiries of management and others within the company provide the auditor with information that he would not have the opportunity to get if he had not make such inquires.


Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
Communications among audit team
Inquires of management
Risk factors (fraud conditions)
Analytical Procedures
Other info
Documenting Fraud Assessment

Sources of information to assess fraud risks

Risk Factors

SAS 99 requires the auditor to evaluate whether fraud risk factors (fraud conditions) indicate ***incentives or pressures*** to perpetrate fraud, ***opportunities*** to carry out fraud, or ***attitudes or rationalizations*** used to justify a fraudulent action.

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***Communications among audit team***
- Inquires of management
- Risk factors (fraud conditions)
- ***Analytical Procedures***
- Other info

Documenting Fraud Assessment

Sources of information to assess fraud risks

Analytical procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable compared to the auditor’s expectations.

- Auditors must perform analytical procedures during the ***planning*** and ***completion*** phases of the audit to help identify ***unusual*** transactions or events that might indicate the presence of material misstatements in the financial statements. “Does it make sense” ?

Sources of information to assess fraud risks

Analytical procedures

Horizontal

The account balance is compared to the previous period, and the percentage change in the account balances for the period is calculated.

Vertical

The financial statement numbers are converted to percentages.

Horizontal Analytical Procedures on Income Statement

	2011	2010	Change	% change
Net sales	143,086	131,226	11,860	9.0 %
Cost of sales	(103,241)	(94,876)	8,365	8.8 %
Gross Profit	39,845	36,350	3,495	9.6 %
G & S & A Exp	(32,475)	(29,656)	2,819	9.5 %
Operating Income	7,370	6,694	676	10.1 %

Horizontal Analytical Procedures:-

The account balance is compared to the previous period, and the percentage change in the account balances for the period is calculated.

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***Communications among audit team***
- Inquires of management
- Risk factors (fraud conditions)
- ***Analytical Procedures***
- Other info

Documenting Fraud Assessment

Sources of information to assess fraud risks

Analytical procedures

Horizontal

The account balance is compared to the previous period, and the percentage change in the account balances for the period is calculated.

Vertical

The financial statement numbers are converted to percentages.

Vertical Analytical Procedures on Income Statement

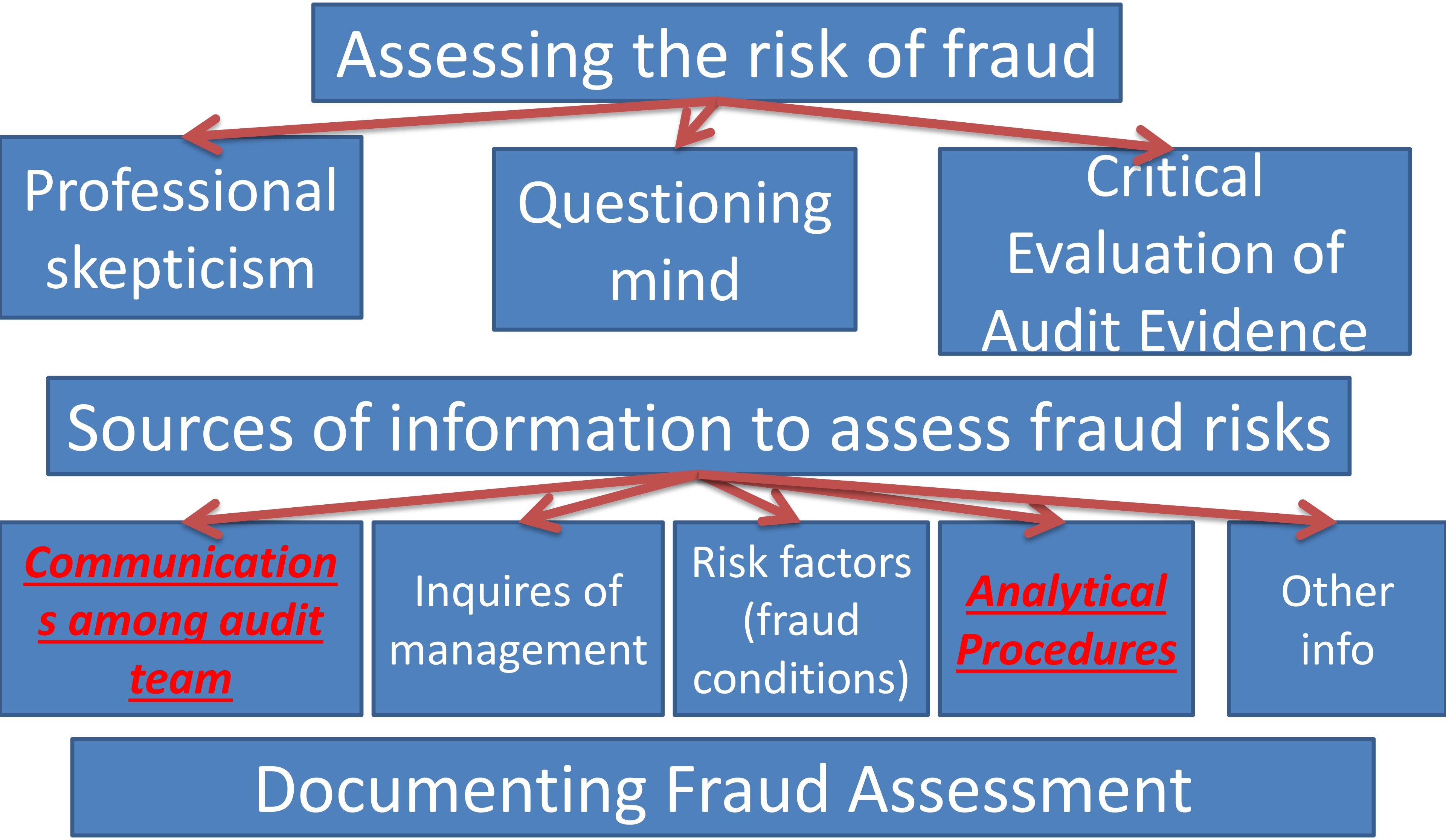
	2011		2010	
		% of Sales		% of Sales
Net sales	143,086	100 %	131,226	100 %
Cost of sales	(103,241)	72.1 %	(94,876)	72.3 %
Gross Profit	39,845	27.9 %	36,350	27.7 %
G & S & A Exp	(32,475)	22.7 %	(29,656)	22.6 %
Operating Income	7,370	5.2 %	6,694	5.1 %

Common Size financial statements

Vertical Analytical Procedures:-

The financial statement numbers are converted to percentages.

Common size financial statement is an example of vertical analytical procedures.


Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
Communications among audit team
Inquires of management
Risk factors (fraud conditions)
Analytical Procedures
Other info
Documenting Fraud Assessment

Sources of information to assess fraud risks

Analytical procedures

Horizontal

Vertical

The account balance is compared to the previous period, and the percentage change in the account balances for the period is calculated.

The financial statement numbers are converted to percentages.

Assessing the risk of fraud

Professional skepticism

Questioning mind

Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

Communications among audit team

Inquires of management

Risk factors (fraud conditions)

Analytical Procedures

Other info

Documenting Fraud Assessment

Sources of information to assess fraud risks

Other information

- Ask the previous auditor about the performance of the client last year, or if he has suffered from scope limitation.
- Information about management honesty and integrity.

Assessing the risk of fraud

- Professional skepticism
- Questioning mind
- Critical Evaluation of Audit Evidence

Sources of information to assess fraud risks

- ***Communications among audit team***
- Inquires of management
- Risk factors (fraud conditions)
- ***Analytical Procedures***
- Other info

Documenting Fraud Assessment

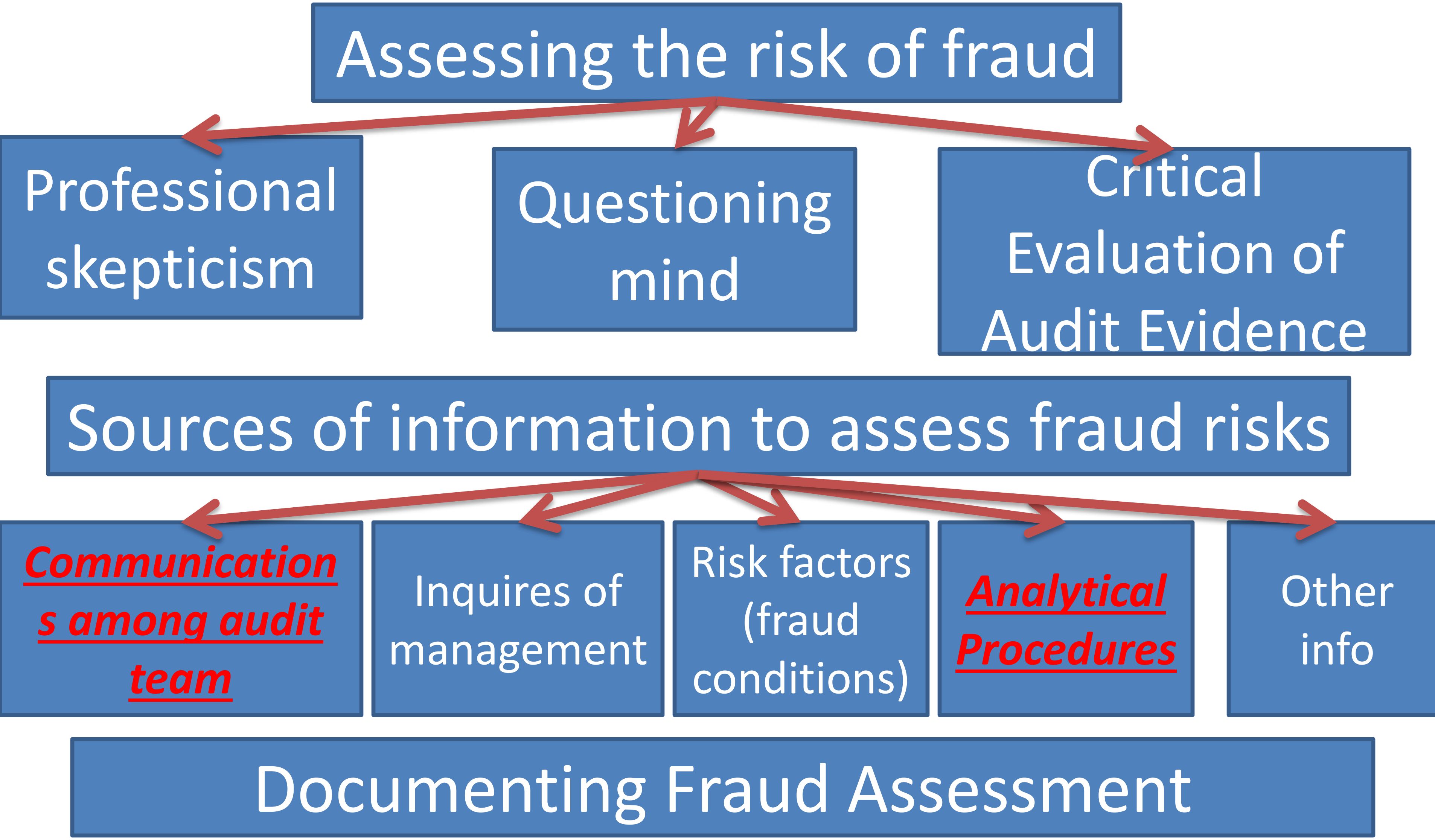
Which of the following is **not a likely source of information to assess fraud risks?**

A) Communications among audit team members.

B) Inquiries of management.

C) Analytical procedures.

D) Consideration of fraud risks discovered during recent audits of other clients



Assessing the risk of fraud
Professional skepticism
Questioning mind
Critical Evaluation of Audit Evidence
Sources of information to assess fraud risks
<u>Communications among audit team</u>
Inquires of management
Risk factors (fraud conditions)
<u>Analytical Procedures</u>
Other info
Documenting Fraud Assessment

Documenting fraud assessment

After you identified and assessed fraud risks, you need to document your findings to your audit file:-

- ***Discussion among engagement team*** about the susceptibility of the client to fraud.
- ***Procedures performed*** to obtain information necessary to identify and assess fraud risks.
- ***Specific risks*** of material fraud that were identified and a description ***of auditor's response*** to those risks.
- Results of procedures performed and reasons supporting a conclusions.
- Communications between the auditor and the management, employees with in the client, and audit committee.

Corporate Governance

- Management is responsible for implementing ***corporate governance*** and control procedures to minimize the risk of fraud, which can be reduced through a combination of prevention (deterrence) and detection measures.
- Fraud prevention (deterrence) is better than fraud detection.
- Since collusion and false documentation make ***detection*** of fraud a challenge (very difficult to detect) (but not impossible), it is often more effective and economical for companies to focus on fraud prevention (deterrence).

Which of the following is the best reason for management to emphasize fraud prevention and deterrence?

A) collusion and false documentation make fraud detection difficult to detect

B) collusion is impossible to detect

C) false Documentation is impossible to detect

D) all of the above are equally valid reasons

Shareholders (owners)

Directors (Board of Directors)

Management (Officers)

Separation between ownership and management

Purpose (interest):-
Generally, investors want their investment to increase overtime

Purpose (interest):-
Want higher salaries, wages, bonus.
<u>May commit fraud</u>

Conflict of interests

<u>So, we need corporate governance</u>

- Corporate governance:- some rules, guidelines, or standards that are designed to organize the relationship between **owners** and ***management*** because conflict of interests may arise.
- Corporate governance tries to protect the rights of ***owners*** against the abuse of ***management and employees*** by monitoring (oversight) the behavior of management and employees.

Elements or mechanisms of corporate governance to prevent (deter) and detect fraud:-

- Culture of honesty and high ethics
- Management responsibility to evaluate risks of fraud
- The role of auditors and audit committee oversight.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Overview

Research indicates that the ***most effective way*** to prevent (deter) fraud is to implement ***antifraud programs and controls*** that are based on core values embraced by the company, not just hiring highly ethical employees.

Research indicates that the most effective way to prevent and deter fraud is to:

A) implement programs and controls that are based on core values embraced by the company.

B) hire highly ethical employees.

C) communicate expectations to all employees on an annual basis.

D) terminate employees who are suspected of committing fraud.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***<u>Code of conduct</u>***
- Hiring appropriate employees
- ***<u>Training</u>***
- Confirmation
- discipline

Management Responsibility

- ***<u>Establish internal control</u>*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Setting the tone at the top

- Honesty and integrity by management reinforces honesty and integrity to employees throughout the organization.
- Management cannot act one way and expect others in the company to behave differently (means if management is dishonest, employees are more likely to be dishonest too and vice versa)
- Management and the board of directors are responsible for setting the “tone at the top” for ethical behavior in the company.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Creating a Positive Workplace Environment

Research shows that wrongdoing occurs less frequently when employees have positive feelings about their employer. If they feel abused, threatened, or ignored, they are more like to engage in fraudulent actions.

A positive workplace can generate better employee morale, which may reduce employees' likelihood of committing fraud against the company.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Code of conduct

For each organization, there is a code of professional conduct. “What can I do and what I am prohibited to do”.

- ***<u>Gifts, entertainment, and favors</u>***:- Employees are prohibited from accepting entertainment, gifts, or personal favors that could influence business decisions.
- ***<u>Kickbacks and secret commissions</u>***:- Employees are prohibited from receiving payment or compensation of any kind, except as authorized by laws.

Culture of Honesty and High Ethics

Code of conduct

<u>Organization funds and other assets</u>:-

Employees who have access to organization funds must follow prescribed procedures for recording, handling, and protecting organization funds.

<u>Organization records and communication</u>:-

Employees responsible for accounting and record keeping are prohibited from making any false record or communication of any kind, whether external or internal.

Culture of Honesty and High Ethics

Code of conduct

- ***Privacy and confidentiality***:- financial and personal information about customers the organization deals with may be used in organization business objectives, not for any personal goals. These kind of information can not be disclosed to any third-parties.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Hiring appropriate employees

To be successful in preventing fraud, well-run companies implement ***effective screening policies*** to reduce the possibility of hiring and promoting individuals with low levels of honesty and integrity. Such policies may include background checks to verify candidate’s education, employment history, his character, references.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Training

All new employees should be trained about how to apply employees' ethical conduct. Employees should be told to communicate any actual or suspected fraud to the management.

Fraud awareness training should be tailored (designed) to employees' specific job responsibilities. For example, different training for purchasing managers and sales managers.

Fraud awareness training should be:

A) broad and all-encompassing.

B) extensive and include details for all functional areas.

C) specifically related to the employee's job responsibility.

D) focused on employees understanding the importance of ethics.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics Confirmation

- Most companies require employees to periodically confirm their responsibilities for complying with the code of conduct.
- Employees should be asked to state that they understand the company's expectations and have complied with code of conduct, and that they are unaware of any violations.
- These confirmations help reinforce the code of conduct policies and also help to deter employees from committing fraud or other ethics violations.

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Culture of Honesty and High Ethics

Discipline

Employees must know that ***they will be held accountable*** for failing to follow the company's code of conduct. Enforcement of sanctions of the code sends a clear massage to all employees that compliance with code of conduct and ethics is important, otherwise they will be punished.

Mechanisms of corporate governance

- **Culture of Honesty and High Ethics**
  - Tone at the top
  - Positive work place environment
  - ***Code of conduct***
  - Hiring appropriate employees
  - ***Training***
  - Confirmation
  - discipline
- **Management Responsibility**
  - ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
  - Mitigating fraud risks
  - Monitoring fraud prevention programs
- **Auditors and Audit Committee**
  - Need for audit committee
  - Need for external auditors

Culture of Honesty and Ethics

- Tone at the top
- Positive workplace environment
- Code of conduct
- Hiring appropriate employees
- Training
- Confirmation
- Discipline

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***<u>Code of conduct</u>***
- Hiring appropriate employees
- ***<u>Training</u>***
- Confirmation
- discipline

Management Responsibility

- ***<u>Establish internal control</u>*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Management Responsibility

Corporate governance requires the ***management to establish and implement internal control system and programs*** that can:-

- Identify and measure fraud risk, and try to prevent (deter) and detect fraud.
- Mitigate fraud risks by designing and implementing programs and controls to reduce incentives, opportunities and attitudes that may lead to fraud.
- Monitoring fraud prevention programs. Management should periodically evaluate whether antifraud programs and controls have been established and are operating effectively.

Management is responsible for:-

	Identifying and measuring fraud risks	Taking steps to mitigate identified risks
a	Yes	Yes
b	No	No
c	Yes	No
d	No	Yes

Management is responsible for making the financial statements.

Generally, fraudulent financial reporting is done by management.

Which of the following parties is responsible for implementing internal controls to minimize the likelihood of fraud?

A) External auditors

B) Audit committee members

C) Management

D) Committee of Sponsoring Organizations

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Auditors and audit committee

Audit committee members should be ***<u>independent</u>*** from management.

Audit committee is responsible for:-

- Oversight the performance of management's financial reporting.
- Watching management and it's internal controls.
- Hiring, and compensating the external auditors.

Who is responsible for establishment and implementing internal controls? Management

Who is responsible for making F.S? Management

Who is responsible to oversee ***an organization's financial reporting*** and internal control process? Audit committee

Which party has the primary responsibility to oversee an organization's financial reporting and internal control process?

A) the board of directors

B) the audit committee

C) management of the company

D) the financial statement auditors

While performing their audit, the audit team uncovers fraud that is likely to have an ***<u>immaterial</u>*** affect on the financial statements taken as whole. In this case the auditors should:

A) plan on additional audit procedures to determine the exact amount of the fraud.

B) communicate with legal authorities as to the identity of the fraudsters.

C) disclose the fraud to the appropriate level of management or to the audit committee.

D) call the whistleblower hotline and name the suspected individuals

As part of the brainstorming sessions, auditors are directed to emphasize:

As part of the brainstorming sessions, auditors are directed to emphasize:

	The need for professional skepticism	The audit team's response to potential fraud risks
a	Yes	Yes
b	No	No
c	Yes	No
d	No	Yes

Shareholders (owners)

Directors (Board of Directors)

Management (Officers)

Separation between ownership and management

Purpose (interest):-
Generally, investors want their investment to increase overtime

Purpose (interest):-
Want higher salaries, wages, bonus.
<u>May commit fraud</u>

Conflict of interests

<u>So, we need corporate governance</u>

Mechanisms of corporate governance

Culture of Honesty and High Ethics

- Tone at the top
- Positive work place environment
- ***Code of conduct***
- Hiring appropriate employees
- ***Training***
- Confirmation
- discipline

Management Responsibility

- ***Establish internal control*** that can Identify, evaluate, and measure fraud risks
- Mitigating fraud risks
- Monitoring fraud prevention programs

Auditors and Audit Committee

- Need for audit committee
- Need for external auditors

Which of the following does NOT represent an increased opportunity to commit fraud?

A) Related Party Transactions Maybe fraud

B) the company founder is the CEO and Chairman of the Board Maybe fraud

C) the financial statements involve accounting estimates Maybe fraud

D) the company is a new audit client for the CPA firm **This is normal**

Which of the following circumstances is ***<u>most likely</u>*** to cause an auditor to consider whether material misstatements due to fraud exist in an entity's financial statements?

A- Management places little emphasis on meeting earnings projections of external parties. Normal

B- The board of directors oversees the financial reporting process and internal control. Normal

C- Significant deficiencies in internal control previously communicated to management have been corrected. Normal

D- Transactions selected for testing are not supported by proper documentation. Warning !

Which of the following characteristics ***<u>is most likely</u>*** to heighten an auditor's concern about the risk of material misstatements due to fraud in an entity's financial statements?

A- The entity's industry is experiencing declining customer demand. Warning

B- Employees who handle cash receipts are not bonded. This is good

C- Internal auditors have direct access to the board of directors and the entity's management. Normal

D- The board of directors is active in overseeing the entity's financial reporting policies. This is good

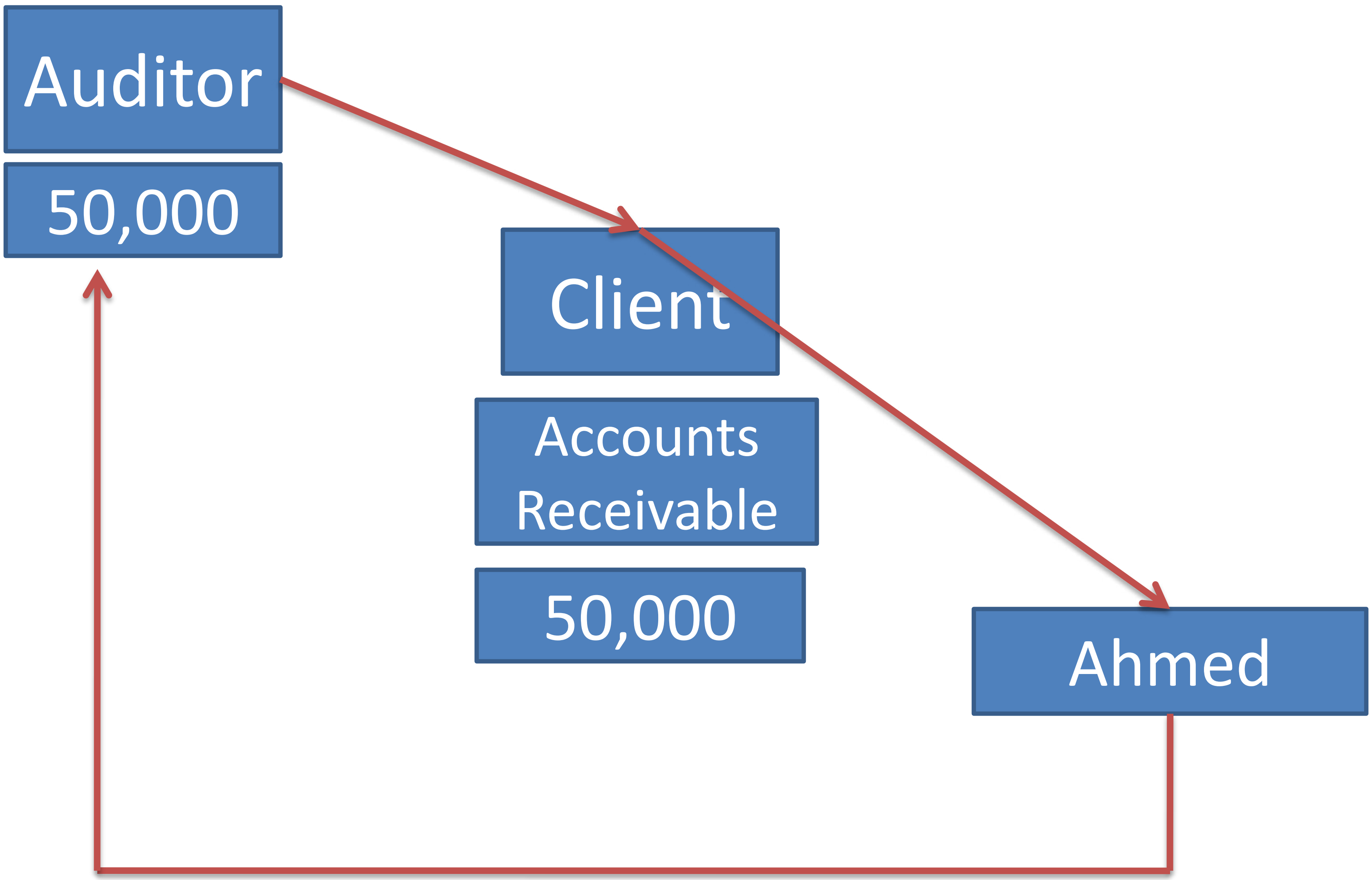
Which of the following circumstances is ***<u>most likely</u>*** to cause an auditor to increase the assessment of the risk of material misstatement of the financial statements due to fraud?

A- Property and equipment are usually sold at a loss before being fully depreciated. Normal

B- Unusual discrepancies exist between the entity's records and ***<u>confirmation replies</u>***.

C- Monthly bank reconciliations usually include several in-transit items.

D- Clerical errors are listed on a computer-generated exception report


Auditor
50,000
Client
Accounts Receivable
50,000
Ahmed

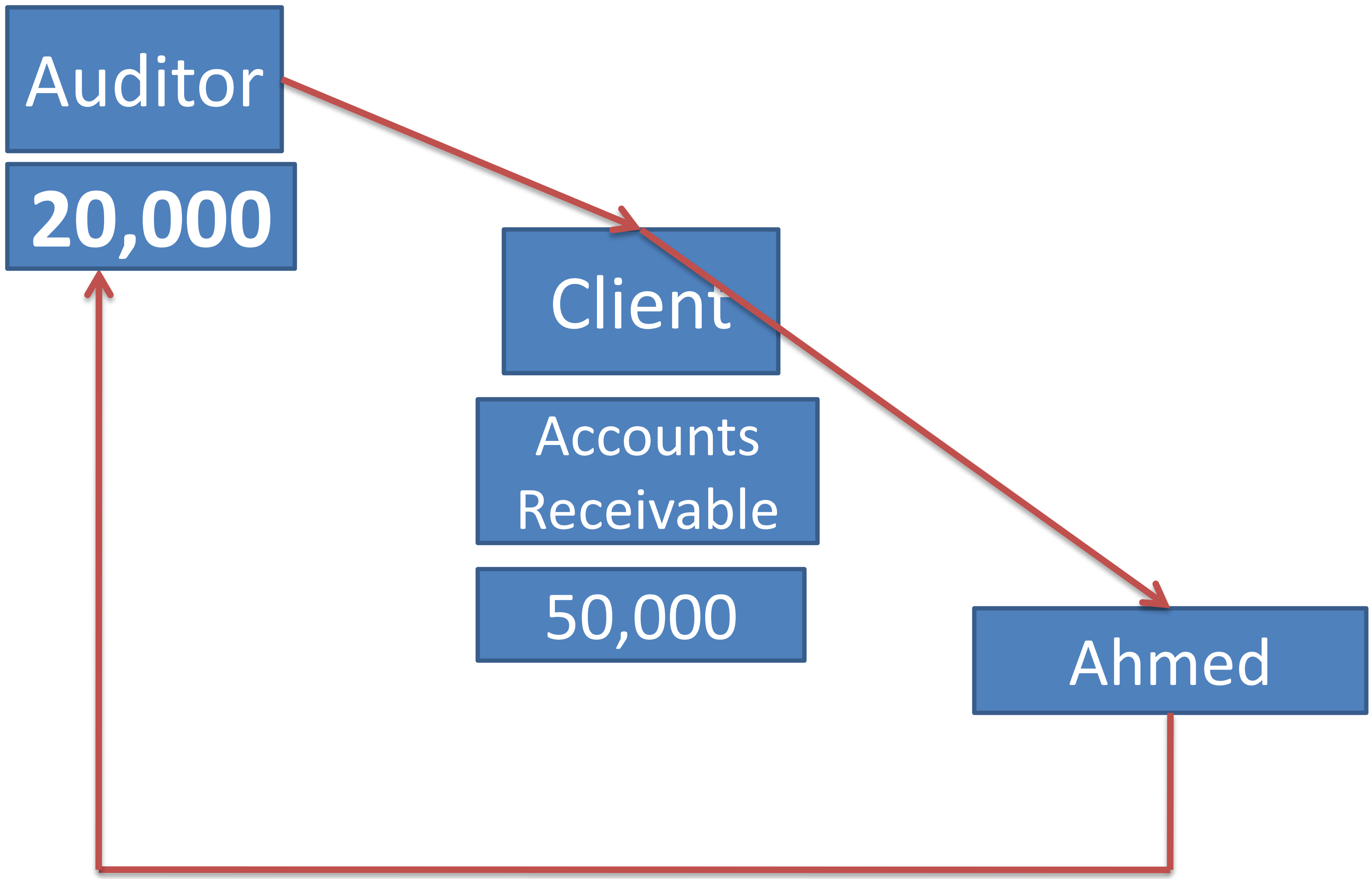
Which of the following circumstances is ***most likely*** to cause an auditor to increase the assessment of the risk of material misstatement of the financial statements due to fraud?

A- Property and equipment are usually sold at a loss before being fully depreciated. Normal

B- Unusual discrepancies exist between the entity's records and ***confirmation replies***.

C- Monthly bank reconciliations usually include several in-transit items.

D- Clerical errors are listed on a computer-generated exception report


Auditor
20,000
Client
Accounts Receivable
50,000
Ahmed

Which of the following circumstances is ***most likely*** to cause an auditor to increase the assessment of the risk of material misstatement of the financial statements due to fraud?

A- Property and equipment are usually sold at a loss before being fully depreciated. Normal

B- Unusual discrepancies exist between the entity's records and ***confirmation replies***. Warning

C- Monthly bank reconciliations usually include several in-transit items. Normal

D- Clerical errors are listed (discovered) on a computer-generated exception report Not Bad